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ABSTRACT

This publication offers a summary of a symposium designed to elicit dialogue on the costs and benefits of eliminating the restrictions on institutional lending in the Stafford Loan Program. Approximately 100 people, representing postsecondary institutions, commercial lenders, guaranty agencies, secondary markets, loan servicing groups, and Congressional staff, attended the symposium. The format of the symposium consisted of four sessions that focused on: (1) the effects of elimination of current lending criteria on institutions, students, and parents; (2) the effects of elimination of current lending criteria on banks; (3) the effects of such elimination on guaranty agencies, secondary markets and servicing organizations; and (4) alternatives to the elimination of current lending criteria. Recurring topics included access, fragility of the program, administrative complexity, loan servicing, program costs, and profit. Highlights of the discussion included the following points: (1) although students currently have access to Stafford loans, signs of erosion are beginning to appear in educational sectors where default rates are highest; (2) it is likely that institutional lending would exacerbate access problems; (3) the Stafford program is currently under considerable pressure; (4) participants' projections of the number of institutions that would become lenders under relaxed legislative requirements varied; and (5) participants expressed concern about administrative complexity and servicing of the Stafford Loan Program. (JB)

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Advisory Committee on Student Financial Assistance
Special Institutional Lender Study

ED357682

Summary of the Symposium on Institutional Lending in the Stafford Loan Program

March 13, 1989
Dirksen Senate Office Building
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Washington, D.C.

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Summary

The Symposium on Institutional Lending in the Stafford Loan Program was designed to elicit dialogue on the costs and benefits of eliminating the restrictions on institutional lending. During the course of the day-long meeting, important issues were also raised within the context of the environment in which the Stafford Loan Program operates. Recurring topics included access, fragility of the program, administrative complexity, loan servicing, program costs, and profit. Highlights of the discussions follow.

- **Students currently have access to Stafford loans, although signs of erosion are beginning to appear in educational sectors where default rates are highest.** Because there is a mismatch between schools that would be able to lend (e.g. traditional four-year institutions with endowments) and schools that would need to lend (e.g. proprietary, vocational/technical, and community institutions), institutional lending was not viewed as an effective measure to counter reduced availability of loans to students. For the most part, only traditional four-year institutions that have access to inexpensive capital would be able to enter the program. These schools enroll students who are less likely to default; commercial lenders, therefore, probably would not deny the students access to Stafford loans in any event. On the other hand, students who are more likely to default -- and, thus, are also more likely to have trouble securing loans from banks -- attend schools that generally do not have the necessary capital to become lenders.

• **Institutional lending would exacerbate access problems.** If many traditional four-year institutions entered the program, the ability of banks to balance their loan portfolios with low and high-risk students would be mitigated. Many banks would leave the program because of the costs and the risks involved in originating default-prone loans. To preserve profitability and reduce liability, the lenders that remain would become more selective by extending loans that have longer statistical lives, higher average balances, and the least chance of default. Secondary markets would also be more careful about the quality of the loan paper purchased, giving lenders additional impetus to turn down students who attend programs that are shorter, who borrow smaller amounts, and who are at higher risk of default.

Access would be further reduced if lenders and secondary markets begin to engage in special arrangements with schools that have low-risk students by providing capital and service for institutional lending. Such arrangements already exist. Several speakers characterized these activities as detrimental to the well-being of the Stafford Loan Program in terms of access because they foster the skimming of loan paper and the concentration of loans to a few lenders and secondary markets.

• **The Stafford Loan Program is currently under considerable pressure.** Environmental factors creating these strains include reduced special allowance, uncertainty about

reinsurance, questionable availability of letter-of-credit providers, and proposed risk-sharing. Many participants perceived these stresses as serious threats to the stability of the Stafford Loan Program because commercial lenders may choose to discontinue their participation. Symposium participants did not appear to believe that institutional lending would alleviate these problems. Rather, institutional lending could increase the fragility of the program, and even undermine it.

- **Participants' projections of the number of institutions that would become lenders under relaxed legislative requirements varied.** Some believed that institutions with means would be enticed into the program in large numbers. By becoming lenders, these institutions would be able to palliate the administrative complexities associated with the Stafford loan. Further, revenues could be used to reduce administrative costs as well as enhance other financial aid funds. Competition for students was mentioned as a reason for less wealthy schools to find ways to enter the program. Others believed that very few schools would become lenders because the costs and liabilities are significant, whereas the level of revenues would be minimal at best. Given the problems that are already surfacing in the Stafford Loan Program and the possibility that institutional lending would exaggerate these problems, participants seemed reluctant to support the removal of restrictions on the chance that only few institutions would become lenders.

- **Some participants suggested that expanded institutional lending would serve as a "spare tire" in case the Stafford Loan Program experiences severe problems.** Others argued that the current law already contains a spare tire for institutions in the form of certain safeguards. These safeguards were defined as the institution's ability to extend Stafford loans to 50% of their students as a lender of last resort.

- **Participants expressed concern about administrative complexity and servicing of the Stafford Loan Program.** Institutional lending was discussed in terms of diminishing the administrative complexity of the Stafford Loan Program, especially for schools that have national enrollments. These institutions must contend with the unique forms, procedures, and rules imposed by various state guaranty agencies. The complexities also affect loan servicing. Although institutional lending might address these issues for schools that are able to become lenders, the discussions at the Symposium indicated that many schools would not have the resources. Some participants noted that there are other ways to reduce the intricacies, such as standardization of the input from guaranty agencies to institutions.

- **There was some variation in opinion of the potential profitability and program costs to institutions if restrictions were eliminated.** Some participants indicated that institutions would realize little profit and that becoming a lender is a very big step to take in order to obtain compensation for the costs of administering the Stafford Loan

Program. One participant suggested that the tax-exempt status of many institutions would diminish overall administrative costs, thus justifying smaller special allowances to institutional lenders. The question was raised whether or not profits realized by tax-exempt institutions extending Stafford loans would be defined by the IRS as unrelated business revenues. There was also some sentiment that institutions should not be motivated by profits.

- **Alternatives to eliminating restrictions were examined.** Suggestions surfaced during the Symposium to improve access, reduce administrative complexity, and address the weaknesses in the current program. Alternatives included:

  - Creating a system of lenders of last resort
  - Revising the Perkins and SLS loan programs
  - Strengthening the partnership among the Stafford Loan Program participants
  - Standardizing forms and procedures

Throughout the symposium, participants raised many concerns, as the preceding summary demonstrates. Student access to the Stafford Loan Program, however, continued to surface as the pivotal issue. Weaknesses in the system and apprehensions about expanded institutional lending as a counterproductive approach were generally

addressed in this context. Institutional lending was not described as method to offset losses to universal access or to compensate for stresses in the current system. Several participants even questioned the value of focusing on institutional lending since there are so many other matters connected to the well-being of the Stafford Loan Program that require attention.

Introduction

The Advisory Committee on Student Financial Assistance sponsored a day-long symposium on March 13, 1989 as a means of obtaining input for the Institutional Lender Study from representatives of the parties involved in Stafford lending. The U.S. Congress mandated the Institutional Lender Study to examine a broad set of questions related to the potential effects of

- removing the current restrictions in the Higher Education Act of 1965, as amended, and
- expanding the institution's role in lending under Part B programs (e.g. Stafford, SLS, and PLUS).

The Congress also expressed interest in substitution criteria, such as the Perkins Loan default rate, as a replacement for the legislative limitations now in place. The underlying issues confronting the study revolve around whether or not institutional lending will:

- improve access and service to students,
- lower the overall costs of the program (e.g. defaults and subsidies),
- strengthen program stability, and
- lead to large revenue windfalls for institutions.

As U.S. Representative Pat Williams stated in his remarks at the Symposium, "While the broad-based questions can be stated simply, the underlying specific questions to which they give rise are, of course, very complex." Brian Fitzgerald, staff director for the Advisory Committee, explained that the complexity emerges from trying to predict how institutions, lenders, guaranty agencies, secondary markets, and servicing agencies will – individually and in relationship to one another – alter their current behavior and role in the programs. A set of simultaneous macroeconomic models would be required. No databases exist, however, to run the models.

As a result, the Advisory Committee devised a multifaceted study to collect information from a variety of sources in order to fulfill the Congress's charge. The study design involves virtually all sectors of the community and draws heavily upon the insights of authorities in the field. Components of the study include a literature review, a series of case studies, formal positions from the community, and a set of analytical papers from experts. The Symposium was intended to enhance these elements of the study through open exchange among the participants in the Stafford Loan Program.

Approximately 100 people attended the Symposium on Institutional Lending in the Stafford Loan Program. They represented postsecondary institutions, commercial lenders, guaranty agencies, secondary markets, loan servicing groups, and Congressional

staff. The following members of the Advisory Committee were also present: James R. Craig, Chairman; Stephen C. Biklen; Edward Elemendorf; James L. Flippin; A. Dallas Martin; and Linus Wright.

The format of the symposium consisted of four sessions that focused on an equal number of topics relating to the study. The topics are:

- The Effects of Elimination of Current Lending Criteria on Institutions, Students, and Parents
- The Effects of Elimination of Current Lending Criteria on Banks
- The Effects of Elimination of Current Lending Criteria on Guaranty Agencies, Secondary Markets, and Servicing Organizations
- Alternatives to the Elimination of Current Lending Criteria

Each session began with short presentations by panelists, who were selected because of their activities in the area addressed by the topic; the question and comment period that followed constituted an essential feature in each session. To facilitate the discussion and maintain a critical approach, the Advisory Committee developed a set of analytical questions for each topic (see Attachment A). These questions were shared with the audience as well as the panelists.

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Characterized by vigorous exchanges of perspectives and ideas among the attendees, the Symposium has provided the Advisory Committee with vital insights into the matter of institutional lending.

Session I -- The Effects of Elimination of Current Lending Criteria on Institutions, Students, and Parents

The speakers for the first panel represented the variety of regional and sectoral concerns among higher education institutions in the United States. The panelists were:

- Robert Hahn, University of Akron
- Marilyn Jaeger, University of California System
- Donald Routh, Yale University
- James Stanley, Phillips Colleges

A. Dallas Martin, president of the National Association of Student Financial Aid Administrators, moderated.

Summary of Presentations for Session I

- **Mr. Hahn** expressed his opposition to removing the restrictions on institutional lending. He stated that it would destabilize the Stafford Loan Program by undermining the partnership among the institutions, lenders, guaranty agencies, and secondary

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markets. He noted his disagreement with the argument that expanded institutional lending would improve loan servicing; he alluded to institutional track records in other educational loan programs in support of this position. According to Mr. Hahn, the current system provides students with the educational benefit of learning to deal with credit from commercial lenders. Relaxing the criteria, on the other hand, would reduce general student access to a postsecondary education because lenders would either leave the program or become more restrictive to maintain a balanced loan portfolio. Those institutions that become lenders would experience a conflict of interest by potentially feeling the need to encourage their students to borrow.

Although he does not support changing the current criteria, Mr. Hahn stated that the University of Akron would consider institutional lending "if the laws were changed to make it more advantageous." The institution, however, would have difficulty raising capital because the University of Akron cannot turn to endowment or operating funds. Mr. Hahn cited lines of credit or loans through commercial lenders or secondary markets, or the bond market as possible sources of capital. The paper would be sold to a secondary market prior to repayment.

Mr. Hahn believes that the current system can be improved by nurturing the partnerships that already exist through "incremental change, not radical reform." He indicated that the establishment of regional, rather than state guaranty agencies would

be beneficial to the Stafford Loan Program. Other suggestions for modification included repayment schedules that are linked to income and a greater proportion of grant to loan assistance.

- **Ms. Jaeger** focused her comments on the University of California System's feasibility study to become a Stafford lender under the current criteria. Although sufficient loan funds are available to UC students, the motivation was based on an interest in augmenting the UC System's grant aid. The initial study assumed that the program would be capitalized from the $6.3 million UC extends annually in low-interest rate institutional loans; the paper would be held while the student remained in school; the loans would be serviced by an outside organization during the in-school period; and the paper would be sold to a secondary market upon the student's termination from UC.

UC discovered that by investing the $6.3 million in the Stafford Loan Program, it would take ten years before sufficient returns were realized to fund other aid programs. Their needs for scholarship and grant funds were so pressing that the decision was made not to use the $6.3 million, but to examine the possibility of borrowing capital either from their own short-term investment pool or from the Student Loan Marketing Association. The arrangement in either case would not generate sufficient profit according to the numbers they ran. As a result, the UC System has chosen not to become an institutional lender.

The Berkeley campus, however, is still exploring the viability of institutional lending. It plans to use its own endowed loan funds in order to make larger loans and to generate profit for other financial aid programs. Berkeley anticipates contracting with an outside servicing agency for the in-school period and then selling the paper when the student leaves. Before Berkeley can begin lending, the university's legal counsel must investigate several questions. First, is the income generated from Stafford lending unrelated business income? Second, will the loans extended by the Berkeley campus be desirable to the secondary market? Finally, will the selection of the secondary market have to go out to bid?

UC-Irvine also considered becoming an institutional lender. Like the UC System, Irvine has decided against it.

- **Mr. Routh** explained his support for institutional lending in the context of Yale University's experience as an institutional lender. He cited five arguments in favor of removing the current criteria. First, institutional lending permits better service to students by integrating the application and award process, improving the timing of disbursements, and mitigating student concerns about availability of loans from year to year. Second, institutional lending assures access. Yale initially became a lender because access was a problem; it is possible for access to become a problem again.

Third, institutional lending promotes administrative efficiency amid the complexity of the Stafford Loan Program. The current lending environment requires schools with national enrollments to contend with many guaranty agencies and commercial lenders. This requires schools to manage varying policies that deal with the guaranty fees charged and the amount of minimum loans permitted as well as a multitude of "different and incompatible forms, data collection, and distribution and disbursement cycles." According to Mr. Routh, "All these problems evaporate as soon as the school becomes a lender."

Fourth, given that schools are held in part accountable for defaults, institutional lending permits the integration of the many aspects of Stafford loan administration. Examples include counseling, packaging, controlling the amounts borrowed, resolving specific problems, and automating loan processing. Finally, institutional lending provides schools with an opportunity to defray administrative costs and to expand financial aid funds.

- **Mr. Stanley** believes that educational institutions should not be involved in the business of lending. He stated that although Phillips Colleges has remained an inactive lender in Georgia and Mississippi in the event access becomes a problem again, he would prefer to leave lending to the banks. He said that there already are signs of

students from the "private career sector" having difficulty securing Stafford loans. Should Phillips Colleges be forced to extend loans to their students, the program would be financed through their operating budget necessitating a reduction in outlays for education purposes such as facilities and textbooks. In addition, the institution would be acting as a lender of last resort, thus increased default rates would be anticipated. Mr. Stanley referred to this eventuality as a "reverse cream" or "sour milk" theory.

Summary of Discussion for Session I

Questions and comments from the audience encompassed a range of opinion. Highlights follow.

- **All the panelists agreed that a lender of last resort program would be an appropriate avenue to solving problems of access.** Mr. Routh added that Yale, as a lender, is equally concerned about easing the administrative complexities associated with the Stafford Loan Program; a lender of last resort would not address this concern.

- **Incidents of problems with access under the current configuration were described.** Mr. Hahn stated banks can control to whom they lend by controlling the distribution of application forms. Mr. Stanley said that some truck driving and health career programs are now experiencing difficulty. Mr. Routh indicated that students who move from

certain states to attend Yale are not able to continue borrowing from their original lender.

- **There was some disagreement about whether or not institutional lending is profitable.** One panelist indicated that institutional lending would be the domain of the "haves," schools that have access to inexpensive capital (e.g. sufficient endowments).

- **The risks inherent in institutional lending were discussed.** Ms. Jaeger indicated that the inability to sell loan paper was of concern to the UC System as they explored whether or not to become a lender. Mr. Routh stated that Yale is always evaluating the program to reduce risk and improve service to students. Yale's considerations include how long to hold paper, whether or not to contract for loan servicing, what sources of capital to use, and to what extent they will market their program to students.

- **Institutional lending needs to be evaluated in the context of other programs.** The Perkins Loan Program was not viewed as viable substitute for the Stafford Loan Program. Grant funds are inadequate to the meet the needs of low-income students. Mr. Stanley indicated that Pell Grants should be made into a true entitlement program.

- **Special relationships among institutions, banks and secondary markets already exist.**

Mr. Routh described a very aggressive market of large banks approaching schools that is as much a factor in "so-called creaming of the loan portfolio" as institutional lending may be. As a result, the issue must be viewed in terms of the administration of the program on a nationwide basis.

Session II – The Effects of Elimination of Current Lending Criteria on Banks

The speakers for the second panel included one bank that was opposed to institutional lending, and another bank in favor. The Special Counsel for the Consumer Bankers Association's Education Funding Committee presented that organization's views. The panelists were:

- William Banks, Chemical Bank
- John Dean, Clohan and Dean/ Special Counsel to Education Funding Committee, Consumer Bankers Association
- Taige Thornton, First Bank System

Stephen C. Biklen, vice president of Citibank, moderated.

Summary of Presentations for Session II

• **Mr. Banks** cautioned that the Stafford Loan Program has an unlimited number of variables. As a result, institutions that consider becoming lenders should take into account the liability and risks as well as the rewards. Mr. Banks prepared a handout (see Attachment B) that showed that the most profitable loans have longer statistical lives, higher balances, and lower delinquency costs. These are the loans normally associated with students who attend "traditional colleges and graduate schools." This educational sector is also perceived to be most capable of acquiring the resources to be come lenders and would predominate institutional lending. Should this occur, banks would be left with loans that have smaller amounts, shorter statistical life, and higher delinquency costs.

Some of the proprietary and trade schools may be able to raise tuition "to cover operating expenses if they had availability of funds for loans." For the most part, however, these schools would not be able to raise the capital for institutional loans given the credit market at this time. Mr. Banks concluded by saying that "to maintain the vitality of the program, it is very important for the legislature not to introduce institutional lending."

• **Mr. Dean** contends that institutional lending will reduce access and increase complexity in the Stafford Loan Program. Access is already becoming a problem for students who are considered high-risk borrowers. This is caused by both the increased

administrative costs and the liability associated with delinquent loans. In turn, with the lower special allowance in place, lender yields are decreasing. Lenders are reducing the number of loans in their portfolios that "require significant levels of due diligence" to respond to these pressures. Institutional lending will not resolve the access problem because the schools that accept high-risk students are not likely to be the institutions able to engage in lending. If banks are relegated to extending loans only to proprietary, community and junior colleges, many lenders will leave the program because they cannot balance their portfolios with high and low-risk borrowers. Further, the number of larger, longer-term loans would be fewer resulting in reduced lender profits.

Mr. Dean addressed the matter of institutional lending as a vehicle to reduce costs to the program. He agreed with arguments that suggest the tax-exempt status of many schools could enable them to realize a profit with a lower special allowance rate. Institutional lending, however, "could require an increase in the special allowance paid for loans made to students attending short-term programs, and also for students in the high-risk categories" thus mitigating any overall savings to the government.

Mr. Dean proposed five problems that could result from widespread institutional lending. First, students may be pressured by schools to borrow. Second, if institutions are held to the same servicing standards as commercial lenders, schools must be

prepared to absorb "large, unreimbursed losses in the event that their servicing or collection of a loan fails." Third, institutional lending will engender sector discrimination because four-year institutions would offer loans to students on their campuses, leaving students who attend other types of schools to obtain loans from banks if they can. Fourth, students with increased indebtedness to their institutions may make lower alumni contributions. Fifth, students effectively will have no choice in selecting a lender.

- **Mr. Thornton** discussed the arrangement in which First Bank Systems and Marquette University were ready to engage prior to the passage of the Technical Amendments in 1987 that reinstated the restrictions on institutional lenders. In effect, Marquette University was prepared to become an institutional lender with the help of First Bank. Mr. Thornton indicated that they believed Marquette would realize a profit intended to help students who would be denied Stafford loans under the revised need analysis. Over time, Marquette would benefit from cost savings in their operations as the school became more experienced with the program.

Mr. Thornton stated that, although he was not prepared to endorse institutional lending "100 percent," the financial services industry is in a state of flux. As a result, lenders that survive will be the ones that "become the most creative in arranging financial services for institutions and families." Concentration is already occurring in the states

that First Bank services, with approximately 60% of the student loans supplied by three or four major banks. Nonetheless, some banks will not be able to compete in an environment of expanded institutional lending; four-year institutions and their students will be the most likely to benefit. First Bank Systems, therefore, is ready to help schools that may not easily benefit (e.g. state, community, and proprietary institutions) gain access to the capital market.

Summary of Discussion for Session II

The discussion succeeding the panelists' presentation stimulated the audience to respond with a variety of questions and comments. The main points appear below.

- **The issue of institutional lending as a means to improve administrative efficiency was raised.** Mr. Banks indicated that institutional lending was not the means to resolve the administrative complexity of the Stafford Loan Program; integrity of data and managing the program like a business would be more effective. Mr. Dean agreed by stating that the negative outcomes of institutional lending outweigh the benefits of a streamlined administration on campus.

- **Institutional lending will not lead to improved access for the shorter-term programs.** Mr. Banks and Mr. Dean agreed with this statement. Mr. Dean explained that there are now too many other dysfunctional features of the Stafford loan such as the special

allowance and uncertainty about reinsurance. As a result, lenders are avoiding loans that require due diligence.

- **A system of last resort lenders was also broached in this session.** Mr. Banks envisions an "A Program" and a "B Program." The "A Program" relates to the current system in which student attending traditional institutions have no problem obtaining access. The "B Program" would be for the rest of community and may contain different requirements such as "heavier counseling." For this to work, Mr. Dean indicated the importance of delimiting the need for lenders of last resort. In addition, Congress would have to offer strong capital incentives in the form of a larger special allowance and 100% reinsurance. Non-financial efforts to keep defaults down such as improved policing of institutions and better counseling are also important. Great care must be taken to examine all proposals in light of weakening the current system and thus scaring away the capital that banks are now providing to needy students on a voluntary basis. Mr. Dean does not believe that the guaranty agencies have the resources to act as lenders of last resort if there is an exodus of lenders from the program. He also commented that this approach makes a program that is "already painfully complex...even more complex."

- **Increasing subsidies to lenders may be an alternative to initiating an "A Program/B Program" approach.** Mr. Dean expressed some hesitance. He suggested that Congress

would probably resist increasing subsidies. Such subsidies, in any event, would have to targeted to address the access problem. Mr. Banks feel that different risks result in differential operating costs, thus supporting differentiated subsidies to lenders.

- **It is questionable whether or not states would have the funds available to students who cannot obtain Stafford loans.** Mr. Dean cited budget restraints within states may prohibit their ability to offer student loans. In addition, there may be a differential effect among states in that some would provide last resort funds while others would not.

- **Institutions seeking credit from banks in order to become lenders would be judged according to their net worth and their cash flow.** Mr. Banks stated that the issue centers on the institution's ability to borrow and ability to service the program. The institution with a lot of money will have no problem obtaining credit. Public institutions may be at a disadvantage if they need a legislative act to make commitments to borrow and to lend.

- **There was no consensus about which institutions would become lenders and how much institutional lending volume to expect.** Mr. Dean suggested that well-endowed schools would participate because of the potential for large profits. Mr. Banks stated that the comments from Session I indicated that few institutions would become lenders

and that there are other pressing issues in the Stafford Loan Program that need attention. One member of the audience stated that maintaining the integrity of the program is important, but if certain high cost schools become lenders the program will not be compromised. Another audience participant noted that it is unclear that wealthy institutions will want to lend, thus questioning the argument that the good paper will be removed from the market. One individual stated that the Department of Education's examination committee should be reinstated to assure that only capable institutions become lenders.

- **There was disagreement about whether or not to leave the current system alone.** One member of the audience stated a preference to work on other issues; another individual said that consideration must be given now to events that might occur in the future. Improving the administration of the Stafford Loan Program and enhancing outreach to high school students were mentioned as more pressing concerns. Mr. Banks concurred with this, stating that individuals who need job training are getting the "short menu."

- **The SLS program is more expensive because of increasing default rates.**

- **The stability of guaranty agencies' reserve funds for insurance influence whether or not lenders continue working with certain educational sectors such as the proprietary and vocational/technical schools.**

- **There was disagreement about whether or not the legislation needs modification in the event access becomes a larger problem.** One member of the audience referred to a "spare tire in the trunk" in case of "pot holes in the road." Another individual maintained that the spare tire already exists in the law because it permits an institution to lend to as many as 50% of their undergraduate student body if students cannot find commercial lenders.

Session III -- The Effects of Elimination of Current Lending Criteria on Guaranty Agencies, Secondary Markets, and Servicing Organizations

The presenters for Session III held different positions on the value of removing the restrictions on institutional lending. Two members of the panel were squarely opposed; one panelist, who represents an organization that works with institutions who wish to become lenders, described eliminating the restrictions as bad public policy; another panelist focused on the current pressures on the Stafford Loan Program. The panelists were:

- Samuel Kipp, California Student Aid Commission
- Roy Nicholson, United Student Aid Funds

- Lawrence O'Toole, New England Education Loan Marketing Association
- Vincent Roig, Arizona Education Loan Marketing Association

James L. Flippin, director of the Mississippi Guaranteed Student Loan Agency, moderated.

Summary of Presentations for Session III

- **Dr. Kipp** referred to institutional lending as a "bad idea whose time hopefully will not come." The institutions with the greatest interest in lending are not the ones with the access problems. Further, most schools would be unable to "marshall sufficient administrative and financial resources to realistically approach the capital markets" in order to become Stafford lenders. With the exception of heavily endowed institutions, schools that participate in the Stafford loan program would have difficulty selling the paper to secondary markets.

Most of the problems the Stafford loan faces today are "back-end" or post-grace period issues such as access to capital markets, access to credit support, and cost of servicing. These factors conspire to put a squeeze on profits for the lenders.

According to Dr. Kipp, institutional lending would undermine the integrity of the program. The Department of Education would be faced with the need to greatly

increase its program review and training support, which Dr. Kipp finds lacking at the moment. In addition, institutional lending removes the checks and balances that are built into the Stafford Loan Program and would result in program abuse. The integrity of the program would also be compromised because there would be an increased reliance on third-party servicers. Dependence on third-party servicers is an issue under the current system; there is a "need for more reasonable due diligence procedures that have a greater emphasis on effectiveness and sensible cures." Because institutions would most likely sell their paper, Dr. Kipp questioned the argument that institutional lending would improve service to students.

- **Mr. Nicholson** stated that there appears to be increasing interest in lending among postsecondary institutions. He also perceives that more schools are becoming lenders. From his experience with USAF, which has a program for institutions that want to be Stafford lenders, schools can realize a profit without risk or cost. Mr. Nicholson reviewed the handout he had prepared for the Symposium (see Attachment C). Even though USAF is engaged in these activities, Mr. Nicholson concluded that institutional lending was not good public policy despite the advantages that an individual institution could obtain.

• Mr. O'Toole prefaced his remarks by stating that there are five educational institutions in Massachusetts that are lenders. The largest, Harvard University, lends as a service to its students and has an extremely well-run portfolio.

The threshold question for Mr. O'Toole is whether or not there is an access problem. At this point, access is not a significant problem although students in certain sectors (e.g. vocational schools, community colleges) are beginning to have some difficulty obtaining Stafford loans. Beyond access, Mr. O'Toole does not believe that institutional lending will lead to better servicing. He indicated that the administrative complexities and risks of failure in loan servicing will provide impetus for schools to stay away from lending. In terms of overall costs to the program, institutional lending will neither increase nor reduce those costs to the government. Further, institutional lending probably does not provide a hedge against banks withdrawing because there is no reason for any entity to want to begin lending if over 10,000 commercial lenders who have been in the business for over 25 years want to get out. This would mean "something bigger is wrong here."

Mr. O'Toole also believes that there are other ways of dealing with institutions seeking to either cover the costs of administering the Stafford Loan Program or enhance scholarship funds. Institutional lending is a "big step" to take to achieve revenues. In this regard, Mr. O'Toole stated that "what the Congress intended by illegal inducements

and what the Department of Education has recently interpreted to be illegal inducements" should be reviewed. The Department's list includes many very worthwhile services to postsecondary schools.

Institutions may not be able to enter the program because the amount of capital necessary is more than most schools can obtain in the capital markets. In other words, "the lenders in this community in the program by sharing risks and by committing capital on their own are providing a service which can't be matched in the scope by colleges and universities." Other institutions will be reluctant because they do not want additional debt reflected on their balance sheets. Institutional lending will present a problem for students who attend more than one institution and cannot continue borrowing from their original school; they will be pushed into loan consolidation.

Institutional lending will shift the focus of secondary markets to the provision of capital to institutions and away from working with banks "to make sure all students who are eligible under the program can attend the institution of their choice." The secondary market that can provide the least expensive capital will also be the entity that will eventually own the loan. In this regard, the Student Loan Marketing Association has advantages over all other banks and secondary markets.

• **Mr. Roig** stated that "if it's not broke, don't fix it," and that the basic problem with the Stafford Loan Program at this point is instability. In Mr. Roig's words, the program has been "changed, prodded, fined-tuned, corrected, you name it" over the last eight years. Institutions and lenders alike have been faced with many new regulatory requirements during this time. Mr. Roig indicated that risk sharing already exists in the program because the guarantee on a loan is lost even if only one phone call or letter is missed. With regard to raising capital, Mr. Roig discussed the disappearance of the letter-of-credit providers after the "California situation."

Mr. Roig presented a hypothetical scenario under institutional lending. He suggested that schools like Harvard and Yale will have their own programs because they have the capital and can easily borrow capital as well. The four-year public institutions would still have access to traditional lending sources. Community colleges would be "scrambling for loans," while the proprietary institutions would have access on "a selective basis by some commercial lenders." Only establishments like Sallie Mae and large money-center banks would be able to provide capital to institutions on a cost-effective basis. The Arizona Education Loan Marketing Association would not be able to compete. The result would be a severe access problem in the state because it will be difficult to maintain a balanced portfolio between higher average loans with lower average loans. Credit providers are even now asking secondary markets to limit the number of proprietary school loans in their portfolios.

The program should be left alone for two years, given all the changes in the past eight, to ascertain what works and what doesn't. Further, access is the key issue and broad-based institutional lending "without safeguards" will promote loss of access.

Summary of Discussion for Session III

The following points were made during the exchange between the audience and the panel.

- **Mr. Nicholson presented the costs in the USAF model which led to some discussion.** Mr. Nicholson said that the information on the handout reflects the actual fees charged by USAF. The model will work for some schools and not for others. Nonetheless, institutional lending is not good public policy. Dr. Kipp believes that most servicing fees are usually higher. Mr. O'Toole expressed concern about the risks institutions will have to undertake as lenders including risks of loss and risks of on-going administrative costs; secondary markets would be cautious about purchasing loans from institutions if any servicing errors occurred while the school held the paper. Mr. Roig added that Stafford loans cannot be assigned in the way the Perkins loans are.

- **There is a need to improve servicing to students.** Dr. Kipp stated that schools with national enrollments find servicing particularly frustrating. He suggested that

standardization of input to schools from guaranty agencies would help to alleviate the problem.

- **The concept of lenders of last resort was raised again as an option for students denied access to Stafford loans.** Mr. Roig stated that state legislatures will not be inclined to fund programs, either through direct expenditures or bond authorizations, for students who default. In terms of the "B Program" concept that was proposed in Session I, Mr. Roig feels that the law must provide certain assurances, such as discounting B Program defaults against any trigger for the guarantor or the originator. Mr. Nicholson cautioned against the concept of a lender of last resort. With budgetary pressures on Congress to decrease the special allowance and rate of reinsurance, a lender of last resort proposal would create a false sense of security "among those who do believe that lenders are crying wolf." Further, Mr. Nicholson questioned the feasibility of a lender of last resort because lenders who do not want to originate loans will have no interest in buying them either. Dr. Kipp echoed Mr. Nicholson's comments by stating that it is neither politically nor commercially feasible for legislatures to establish programs to purchase loans no one wants to purchase.

One member of the audience commented that institutions with sufficient capability, as determined by the Department of Education, should be permitted to lend; for historical reasons, his state would not support a lender of last resort program. Mr. O'Toole

agreed that individual schools should not be precluded from lending; the issue is broader, however. In Massachusetts, institutional lenders are doing a very good job of servicing their loans and "they make a contribution to their own students in doing so." These institutions only represent a minimal percentage of the total loan volume in the state, thus permitting commercial lending community -- which has been in the program for 33 years -- to offset the risks of assuming higher risk loans. Mr. Roig stated that the current law provides sufficient safeguards in case access for an institution becomes a problem.

• **Guaranty agencies may perceive institutional lenders differently from commercial lenders.** Dr. Kipp stated that institutional lending upsets the checks and balances in the system. Aside from institutions "certifying to itself that the student was eligible ... for the loan," the arrangements that may occur among schools, secondary markets, and servicing organization result in "an incentive structure that says "Go" at every point." Mr. Nicholson commented that it is very easy to obtain the Department of Education's approval to become lender, just as it is easy to obtain approval to be an eligible institution.

Session IV -- Alternatives to the Elimination of Current Lending Criteria

The speakers for the final panel directed their comments to options that may be placed in lieu of the current institutional lending restrictions. The presenters for Session IV were:

- William Banks, Chemical Bank
- Arthur Hauptman, Educational Consultant
- Samuel Kipp, California Student Aid Commission

Brian K. Fitzgerald, staff director for the Advisory Committee on Student Financial Assistance, moderated.

Summary of Presentations for Session IV

- **Mr. Banks** centered his talk around the lender of last resort concept that had been discussed throughout the day. He stated that the four-year colleges and graduate schools are not subject to high default rates; trade, proprietary, and some two-year colleges are. The "A Program" and the "B Program" would deal with this issue. From the perspective of consumerism, there has to be a connection between an education and obtaining a job. A lender of last resort (e.g. the B Program) minimizes costs of the program. Strict policies would have to be established to properly monitor the program.

- **Mr. Hauptman**, who is not in favor of changing the restrictions on institutional lending, maintained that in the current environment very few schools will become lenders. The remarks made during the previous sessions pointed out that "nobody seems to like the idea" including institutions, banks, guaranty agencies, and secondary markets. Mr. Hauptman indicated, however, that the environment will not stay the same and assuming the posture of "everything is fine – please leave us alone" is not sufficient.

Mr. Hauptman said that although access is an important issue, it is not the only matter that needs to be addressed. He cited four more. First, the cost of the Stafford Loan Programs' dependence on banks is high because the banks will not permit necessary changes to the program. Second, the cost of the program could be reduced by shifting some lending into the Perkins and SLS programs. Third, the savings that would be realized by shifting to Perkins and SLS loans could be used to fund to grants. Finally, concern about eligibility criteria for institutional lending may be exaggerated because there are at least some institutions that have better credit that the S&Ls. Nonetheless, if institutional lending became more widespread, strict participation criteria should be imposed, such as requiring schools to sell the paper unless they could demonstrate high quality in-house servicing.

Mr. Hauptman suggested two alternatives. First, the SLS program should be opened to undergraduate students, who should be permitted to defer payment on the interest by letting it accrue. Institutions could subsidize these loans "either by drawing down the interest rate, or by providing the in-school interest." Providing subsidies is less costly that providing grants on the same scale. This program should not be viewed as a means to make a profit or to break even. Rather, the program should be considered a way to "make an attractive loan plan available" to students and parents. The paper could be sold which Mr. Hauptman sees as a particularly positive feature – one that makes it more advantageous than the Perkins loan.

The second alternative involves the Perkins Loan Program. Mr. Hauptman suggested that the Perkins loan could be reformed into an insured program, with fees that would be charged to students to serve as an insurance fund. Institutions may borrow to finance the program rather than depend on the Federal Capital Contribution. Students would be able to take advantage of consolidation. This configuration would have room for commercial lenders to provide Stafford loans while Perkins loan would go to the institution's needy students and SLS to its non-needy students. This iteration would be less expensive to the government.

- **Dr. Kipp** believes that the partnership in the Stafford Loan Program is a very positive feature that yields $12 billion in financial aid at one-third the cost to the

government. The current structure has strength, while containing elements of fragility. Institutional lending would create an imbalance that would undermine the current system which, according to Dr. Kipp, cannot be squeezed any more.

Dr. Kipp indicated that there are two basic issues that need to be addressed. The first revolves around the "front end" of the program and includes the need to clean up accreditation and licensing standards. The second set of issues deals with the "back end" challenges. These include the major costs and risks that occur after the grace period ends, the maintenance of a healthy secondary market, and "the availability of credit enhancement and support."

Dr. Kipp stated that the public confidence in the effectiveness and the integrity of the Stafford Loan Program needs to be restored. Further, lender focus on costs and on where to direct funds for lower risk and better investment will result in lenders shying away from certain students and certain sectors. This is already occurring. Lenders also may withdraw from some guaranty agencies after a careful examination of their reserve funds ability to deal with insurance.

The Stafford Loan Program is currently subject to micromanagement and an ever-changing system that is more focused on compliance than results. Dr. Kipp stated that institutional lending will not resolve these problems. He indicated that he didn't think

the system is "broken," even though changes need to be made. He is in favor of restoring the partnership and feels no other program can provide this kind of leverage in "a period of both major state deficiencies and national budget deficits."

Summary of Discussion for Session IV

- **There was disagreement about whether or not the program should be left alone.** Dr. Kipp indicated that the program should not be disturbed; the Stafford Loan Program is not that expensive. Mr. Hauptman held the opposite view, revealing his concerns about the costs of the program, especially if interest rates go up. One member of the audience agreed that interest rates are the most explosive aspect of the Stafford loan, but this could be adjusted by turning the program into a market rate loan.

Another member of the audience stated that the most important priority is the program; the cost is second. Mr. Hauptman said he agreed with that point. He stated, however, that if the program were to be created from scratch, the system would not be configured as it is today with "the federal government paying the first dollar of default" and high subsidies.

- **Guaranty agencies may not wish to become lenders of last resort.** One participant said that need analysis has changed the population obtaining Stafford loans by driving non-needy students out of the program. The current law would have the guaranty

agencies act as lenders of last resort, but they do not have the funds. Further, last resort paper is bad by definition. If guaranty agencies act as last resort lenders, defaults would count against the trigger and thus would reduce reinsurance.